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ECONOMIC IMPACT OF THE 1982 "BULL MARKET"

A STAFF STUDY

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LETTER OF TRANSMITTAL

OCTOBER 25, 1982.

Hon. HENRY S. REUSS,
Chairman, Joint Economic Committee,
Congress of the United States, Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to transmit herewith a study entitled "Economic Impact of the 1982 'Bull Market.'" The study was prepared by Dr. Lowell E. Gallaway of the Joint Economic Committee staff.

This study examines the economic impact of the significant rise in the stock market since August. It shows that household wealth has increased by about $600 per person in this period. And because this wealth is highly liquid, it is likely to give an important boost to both saving and consumption. Moreover, if one also includes the increase in value of stocks held by pension funds, the increase in wealth rises to about $1,000 per person, with 46 percent of the wealth accruing to families with incomes of less than $25,000 per year.

Sincerely,

ROGER W. JEPSEN,
Chairman, Subcommittee on Monetary and Fiscal Policy.

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ECONOMIC IMPACT OF THE 1982 "BULL MARKET"

By Lowell E. Gallaway*

I. INTRODUCTION

The evidence that has been reported indicates that the substantial increase in common stock prices of recent weeks, the "bull market" of 1982, has contributed greatly to a "reliquification" of American households, laying the groundwork for the development of substantial positive impetus of the American economy, in both consumption and savings. This has been accomplished through the injection of approximately a $1,000 per capita increase in wealth holdings, 60 percent of which is in the form of a direct increase in household net worth, with the other 40 percent being indirect, stemming from enhanced asset holdings of private and public pension systems. Further the distribution of these gains across the economy appears to be quite widespread. Should stock prices continue to rise to the levels being predicted by some analysts, the increase in relatively liquid wealth that would result would be even greater. Whatever, it would seem that the "bull market" of 1982 has laid, and is laying, the foundation for substantial progress in promoting economic growth in the United States.

*Dr. Lowell E. Gallaway is an economist on the staff of the Joint Economic Committee.

II. HOUSEHOLD LIQUIDITY IN THE 1970's

One of the critical impacts of the long episode of progressive escalation of the rate of price inflation that began in the 1960's and ran through the 1970's was the "deliquification" of American households and the eroding of the asset base of many of the pension systems that constitute the promise of future well-being for millions of citizens. The process is a simple one. As prices start rising more and more rapidly, people begin to anticipate further increases. Anticipated price inflation then impacts on interest rates by adding an inflation premium on to the normal interest rate. Rising interest rates, in turn, depress bond prices, making them more attractive relative to common stocks, driving the prices of stocks down, relative to the price of other assets in the economy.

The impact of this process in the late 1960's and 1970's on real stock values is shown in Table 1. In 1965, the real value (1967 dollars) of stocks traded on the New York Stock Exchange was $568 billion at the close of the year. At the close of 1979, that same figure is $442 billion, *a decline of 22 percent.* The effect on household net worth of the decline in the value of stock equities is twofold, altering the level of asset holdings, as well as the composition. In 1970, for example, the ratio of household net worth to Gross National Product in the United States was about 2.5. By 1980, it had fallen to about 2.2, meaning that American households had about 12 percent less in the way of assets per dollar of GNP in 1980 than in 1970. (See Table 2.)

TABLE 1.—REAL VALUE OF STOCKS LISTED ON NEW YORK STOCK EXCHANGE (1967 PRICES), 1965–79

[In billions of dollars]

Year	Value of stocks at close of year	Year	Value of stocks at close of year
1965	568	1977	439
1970	547	1978	421
1975	425	1979	442
1976	503		

Source: New York Stock Exchange, Inc.

TABLE 2.—LIQUIDITY RATIOS, HOUSEHOLDS, UNITED STATES, 1970 AND 1980

Liquidity ratio	1970	1980
Total household net worth/Gross National Product	2.5	2.2
Liquid household net worth/Gross National Product	1.7	1.4
Liquid/illiquid assets	2.1	1.7

Source: Federal Reserve System.

The decline in the ratio of household assets to Gross National Product reflects a marked slowing in the rate of growth of household net worth. Roughly, in the 1950's, household net worth grew at 5 percent a year; in the 1960's, it advanced by 3½ percent a year; and, in the 1970's, by 2 percent a year. Since then, it has fallen, with the 1981 level of household net worth being less than that of 1978.

In addition, the composition of asset holdings of households had changed in a fashion that made them less liquid. If financial assets are viewed as relatively liquid and tangible assets, such as houses and consumer durables, as relatively illiquid, the shift towards less liquidity becomes apparent. In 1970, the ratio of financial, or liquid, assets to tangible, or illiquid, assets was 2.1. By 1980, it had fallen to 1.7, as household asset portfolios shifted away from financial toward tangible assets. (See Table 2.) A major factor in this shift is a decline in the importance of common stock in the household asset portfolio. In 1970, such holdings represent almost 20 percent of household assets. By 1980, they account for only 12 percent of such assets.

The shift in the composition of household assets in the 1970's accentuates the changes in the level of household net worth. Comparing the volume of liquid household assets to the level of Gross National Product (see Table 2) shows that household liquidity relative to Gross National Product declined by 17 percent between 1970 and 1980, largely as the result of the pattern of behavior of common stock prices.

Beyond the impact on household net worth, changes in the real value of common stock holdings have had a significant effect on the assets of such important institutional investors as pension funds, particularly of the private variety. In 1970, over 44 percent of the assets of private funds were in this form. By 1980, this had fallen to 38 percent and, in 1979, was as low as 34 percent. (See Table 3.) In the case of public pension funds, there has been a secular trend toward greater investment in common stocks as legal restrictions and legislative attitudes have changed. Currently, common stock holdings make up about 20 percent of the assets of State and local government pension funds. Again, see Table 3. From these simple statistics, it is obvious that variations in the level of common stock prices have very substantial implications for the integrity of many pension systems in the United States.

TABLE 3.—ASSETS OF PRIVATE AND PUBLIC STATE AND LOCAL GOVERNMENT PENSION FUNDS, 1960–80

[In billions of dollars]

Year	Total assets		Assets in form of common stocks		Percent common stocks	
	Private	Public	Private	Public	Private	Public
1960	57.0	33.8	16.5	0.6	28.9	1.8
1965	100.9	53.8	40.8	2.5	40.4	4.6
1970	151.6	87.8	67.1	10.1	44.3	11.5
1975	219.0	146.7	88.6	24.3	40.5	16.6
1980	444.8	284.3	168.2	54.3	37.8	19.1

Source: Federal Reserve System.

III. THE IMPORTANCE OF HOUSEHOLD LIQUIDITY

How important is household liquidity in a modern economy? Very—according to the various theories that attempt to explain the behavior of consumption expenditures. The more sophisticated versions of such theories incorporate the wealth holdings of households as an independent variable that influences the level of consumption outlays. The logic of doing this is impeccable. The greater the wealth of a household, the greater its flexibility from the standpoint of making consumption decisions. With higher levels of wealth, especially of the more liquid kind, individuals will feel freer to make additional commitments to consumption. While there may be argument and debate as to the quantitiative impact of greater wealth holdings on levels of consumption, there is a theoretical consensus that it has a positive effect.

The operation of this wealth effect can be complex, though. There are other factors, besides wealth, that influence consumption and a decline in wealth, relative to income, can interact with them in a fashion that produces a decline in the fraction of current income that is saved. As the wealth/income ratio falls, consumption expenditures are more heavily influenced by current levels of income. To the extent that households attempt to maintain customary levels of consumption expenditures in the face of a sharp decline in their wealth position vis-a-vis their income, such as that which occurred in the 1970's, the proportion of current income that will be devoted to consumption is likely to rise. Conversely, the proportion of current income devoted to savings will fall. This is what eventually happened in the 1970's. Saving amounted to 8.0 percent of disposable income in 1970 and fell to 5.7 percent in 1980, a decline of roughly 30 percent. The implications of this for the process of capital formation and economic growth are obvious. A relative lack of liquidity on the part of households has the potential for impeding private saving and slowing the process of economic growth.

With this in mind, the developments of the past several weeks with respect to the behavior of common stock prices take on a much more significant role. Since August, stock prices, as measured by the Dow Jones average, have risen by over 30 percent. In his testimony before the Joint Economic Committee at the October 20th hearing dealing with the third quarter 1982 Gross National Product statistics, Allen Sinai, of Data Resources, Inc., estimated that the "bull market" of late summer and early fall, 1982, had added perhaps $120 billion to the wealth of American households.

Such an infusion of wealth of a relatively liquid type has the potential to accomplish two things: First, a rise in consumption spending, and, second, a rise in the fraction of current income that is saved. Contradictory as it may sound, both consumption and saving are likely to be stimulated by the current rise in the prices of common stocks; consumption, directly, by the greater availabil-

ity of highly liquid wealth, and saving, by a partial substitution of wealth induced consumption for consumption out of current income. This process can be thought of as the "reliquification" of the American economy. And, the effects are likely to be very substantial. Per capita, the infusion of relatively liquid wealth generated by the recent surge in stock market prices amounts to more than $600 per person. To the extent that the increase in stock prices continues, the gains can be even greater. A rough rule of thumb is that every 10 percent rise in stock prices, over their August 1982 low, adds about $175 to per capita wealth holdings. If the "bull market" should continue as many analysts are predicting, it is entirely possible that the per capita increase in wealth holdings will be in the neighborhood of $1,000. (See Table 4.)

TABLE 4.—*Increase in household wealth*

Dow Jones industrial average:	*Per capita* [1]
925	$350
1,000	525
1,075	700
1,150	875
1,225	1,050

[1] Calculated from the stock market's low point in August 1982.

Source: Author's calculations.

IV. THE IMPACT ON PENSION FUNDS

A less obvious effect of the "bull market" on the asset position of Americans is the impact it has had on the stability of the various private and public pension funds that include substantial holdings of common stocks in their asset portfolio. As noted earlier, in the case of private pension funds, common stock holdings make up about 40 percent of the assets of such systems. This means that a 10 percent rise in stock prices has the potential for producing a 4 percent increase in the value of the assets supporting private pension programs. The recent 30 percent rise in the price of corporate equities translates, roughly, into a 12 percent increase in the assets of private pension programs.

In the case of public pension systems at the State and local government level, the effect in not as large, but it is substantial. Here, a 10 percent rise in common stock prices produces about a 2 percent increase in total asset values. Thus, the recent "bull market" may have provided a 6 percent increase in the value of the assets supporting public retirement programs.

Increases in the value of the assets supporting private and public retirement systems that have common stock holdings is welcome in an environment in which great concern about the integrity and stability of these programs frequently is expressed. Indirectly, households in the United States have had their wealth increased by perhaps an additional $85 billion—nearly $400 per capita—in recent weeks as the result of the enhancement of the asset position of pension funds of which they are members. The effect of this on consumption and saving is much more problematical than in the case of the direct infusion of wealth. However, its contribution to individuals' sense of well-being and security should be substantial.

In combination, the $600 direct and $400 indirect wealth effects resulting from the current "bull market," amount to almost $1,000 on a per capita basis, with the potential for even greater gains in the future. If the current trends continue, great strides can be made in alleviating the stresses in the economy generated by the "great deliquification" that occurred during the 1970's.

V. THE DISTRIBUTION OF THE GAINS FROM THE "BULL MARKET"

When dealing with questions of increases in wealth, it is interesting to ask, "Who are the beneficiaries in the society?" Not all households have wealth of the type under discussion. In particular, it would seem to be desirable to have some idea as to which income classes in the economy benefit from the recent rise in stock prices. In order to answer that question, it is necessary to apportion the increase in wealth among income classes. To distribute the gains accruing from the direct infusion of wealth to households, it is assumed that common stock holdings are proportional to the amount of dividend income received. Since the Internal Revenue Service reports such information by income class, it is a rather straightforward matter to allocate the $120 billion addition to household wealth by income class.

The indirect effect is harder to gauge. However, a reasonable approximation would seem to be to allocate this increase in wealth on a per capita basis. While not perfect, it should be useful. When this is done and the two allocations are combined and expressed as a percentage distribution, by income class, the results reported in Table 5 are obtained. Basically, they indicate a fairly wide distribution of the wealth gains, with almost half (46 percent) being captured by those with income levels of less than $25,000.

TABLE 5.—*Distribution of wealth gains from rise in stock prices in "Bull Market" of 1982, by income class*

Income class	*Percent of gains accruing to*
Under $25,000	46
$25,000 to 49,999	19
$50,000 to 99,000	13
$100,000 and over	22

Source: Calculations from Internal Revenue Service data.

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